AN ADVERSARIAL ETHIC FOR INVESTING

Introducing Investors to the Market Failure Approach

Master's Thesis in Applied Ethics

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Abstract

Much of today's discourse on ethical investing is concerned with incorporating social responsibilities into the practice of investing. The debate is often concerned with the moral responsibility of shareholders and complicated by their limited influence. As a response to the ongoing debate, this thesis sets out to construct an ethical framework in which the moral responsibilities of actors on the capital market are derived from the institutional framework of the capital market. I start out by taking a simplified concept of investing, namely that of productive investments only. Continuing, I consider the adversarial nature of these investments, which entails that investing requires antisocial behavior in order to produce beneficial outcomes for society as a whole. However, the logic by which the capital market is supposed to provide an efficient distribution of resources is based on an idealized theory of investing. The imperfect nature of the capital market implies that some strategies can lead to an inefficient outcome. Exploiting these strategies, I conclude, is immoral, for it turns a necessary evil into a mere evil. This approach serves to consider the acts of investing in light of its designated purpose, namely to benefit society as a whole. Furthermore, this approach provides a new look on shareholding, by considering it a fix to a capital market failure.

Table of contents

1. INTRODUCTION **5**
1.1 PRODUCTIVE INVESTING AND TRADING 5
1.2 THE ETHICS OF INVESTING: AN OVERVIEW 7
1.3 PLAN OF THE THESIS 10
2. THE MARKET FAILURE APPROACH **12**
2.1 ON THE MORAL OBLIGATIONS OF MANAGERS 12
2.2 ON THE ANTISOCIAL SIDE OF BUSINESS 15
2.3 ON THE JUSTIFICATION FOR COMPETITIVE BUSINESS 16
2.4 ON MARKET FAILURES AND THE MORAL OBLIGATION OF MARKET COMPETITORS 18
2.5 CONCLUDING REMARKS ON THE MARKET FAILURE APPROACH 21
3. THE ETHICS OF PRODUCTIVE INVESTING **23**
3.1 ON THE ADVERSARIAL NATURE OF INVESTING 23
3.2 ON THE JUSTIFICATION FOR INVESTING 24
3.3 INTRODUCING THE CAPITAL MARKET FAILURE APPROACH 26
3.4 ON THE ROLE-SPECIFIC OBLIGATIONS OF ACTORS ON THE CAPITAL MARKET 30
3.4.a the role of the state *30*
3.4b the role of the firm *31*
3.4c the role of the investor *32*
3.5 CONCLUDING REMARKS ON THE CAPITAL MARKET FAILURE APPROACH 34
4. DISCUSSION **37**
4.1 ON THE RELATION BETWEEN CORPORATIONS AND CAPITAL MARKET FAILURES 37
4.2 ON THE IMPLICATIONS OF THE CMFA ON SHAREHOLDING 40
5. CONCLUSION **42**
REFERENCES **43**

1. Introduction

Much of today's ethical discourse is concerned with the investing practices of the "typical non-professional individual investor" (Sandberg, 2008). Such an investor generally invests his resources in financial services, such as banks and pension funds. Recently, these financial services have tried to accommodate to the moral concerns of regular people. This has lead to the socially responsible investment (SRI) movement, the movement in banking that aims to incorporate ethics in the practice of investing. However, the theoretical underpinnings of this movement are often criticized to be too little concerned with ethics. A theory underlying ethical investing practices should refer to a principle, or set of principles, which can serve to explain the moral reasons for (refraining from) investing. In this introductory section, I will briefly review three ethical approaches to investing and highlight their shortcomings. But before that, I will define the type of investing this thesis is concerned with.

1.1 Productive investing and trading

Investing is a general term that signifies the spectrum of commercial activities involved with foregoing immediate consumption of resources in the expectation of a return. These activities range from the renovation of a house to the high-frequency trading of derivatives on financial markets. This plural understanding of what investing exactly is, might lead to a misconducted debate. I therefore want to dedicate this first subsection of the introduction to defining the sort of investments this thesis will be concerned with.

In this thesis, I will make the distinction between productive *investing* and *trading*, both of which are generally considered investing. By productive investments, I understand investments that are to some extent *irreversible* (Sauner-Leroy, 2004). This includes investing resources in a machine to increase the productivity of a firm, or investing resources in one's education to increase one's own productivity later in life. Generally, the profitability of these irreversible investments depends upon an increased future productivity of some commercial activity, which will generate a return. The second type of investing I distinguish is trading. Trading involves the

buying and selling of financial securities (e.g. stocks, bonds, but also derivatives such as futures and swaps; Hendry, 2013), which occur most often on stock exchanges. Buying a financial security is a reversible investment, for an investor can recoup the monetary value of the investment as long as he finds someone to buy his security back (Ciepley, 2013).

In this thesis, I will be focusing on productive investments. The reason for this is that the operations of productive investments are much closer to our common sense definition of investing than is trading. The misunderstanding to what trading entails is well illustrated by Marjorie Kelly (1997), as she describes many to think: "''I have invested in AT&T,'' […] imagining AT&T as a steward of our money, with a fiduciary responsibility to take care of it. In fact, dollars don't go to AT&T, but to other speculators." Furthermore, when we talk about investing in the sense of trading, most often we talk about shareholding. The special position of the shareholder in the corporate structure of a company, however, further complicates the debate on investing. The owner-like status of shareholders inclines many to ascribe owner-like responsibilities to shareholders (cf. Sorell and Hendry, 1994), which can count on the immediate reply that shareholders' power is too insignificant to really make a change (cf. Klonoski, 1986). Finally, the context trading can raise questions to whether investments, with the only purpose to change a company's behavior by becoming a voting shareholder, should be considered investments (Sandberg, 2008, pp11-2). In contrast, in the case of productive investments it is difficult to imagine the investee agreeing to some loan in which the investor seeks to oppose the goal of the investee. A more limited conception of investing will serve to compose a more comprehensive ethical framework of this type of investing. Moreover, I hope to show that this structure does provide a new insight on the purpose of trading. To summarize, this thesis will limit its scope to *productive investments*, between *separate actors* on the *capital market*.

Why do I explicitly mention to be concerned with investments between *separate actors*? And what exactly is the capital market? Well, in this thesis I start out from a classical economic perspective on investments (similar to Heath, unpublished, pp316-40), which assumes individuals make commercial decisions based on the maximization of personal satisfaction. Furthermore, the capital market can be

distinguished from the financial market, as the latter is involved with investing as trading, and the former as productive investing. The capital market is characterized by, on the one side, individuals willing to pursue commercial opportunities who lack the resources to do so, and on the other side, individuals with resources to spare who want to "put their capital to work". In the real world, however, individuals have collaborated in the form of firms. Internal investments—redirecting resources within the borders of the firm—can be seen as productive investments as well, but are different of character for the demand for resources is not competitive. Such investments are what Heath calls "administrative transactions", governed by the rules and structure of the firm rather than the market (Heath, 2007). What I am interested in is the competitive nature of investing, which turns the investee into a mere means to profit for the investor, rather than an end in itself. Moreover, the difference of interests between the investor and the investee is fertile ground for many fundamental questions to the ethics of investing.

1.2 The ethics of investing: an overview

In this subsection I will provide a brief overview of the ethics of investing, based for an important part on the extensive review of Joakim Sandberg (2008). I will consider three perspectives, namely that 1) one should avoid investing in companies whose practices are in contradiction to one's moral beliefs, 2) one should avoid investing in an evil company per se, and 3) one should act as a responsible investor. Before I start, I want to acknowledge that these principles are concerned with shareholding mainly, which is not my subject of inquiry. However, I believe that they also apply to the context of productive investing, albeit sometimes in a slightly altered form.

Today's ethical discourse on the subject of investing is occupied mainly by the question of how individual investors can invest in a socially responsible manner. Suggestive of this statement is that it distinguishes between the normal investor and the socially responsible investor (Hasnan, 1998). "A normal investor invests out of self-interest, while a socially responsible investor invests *also* out of a social concern," the statement indicates. This perspective can be found back in the understanding of the SRI movement that aims to incorporate social responsibilities into the practice of investing. This approach has driven investment portfolios to

become like consumer products, as investment funds have created their portfolios to tailor to widely shared concerns, without an underlying ethical principle to determine which practices are avoided and/or engaged in. What is distinctly ethical about these ethical investments is not always clear. The main theme of this approach, however, seems to be that it is wrong to behave in contradiction with one's moral beliefs. Critics of this interpretation point out that this kind of ethical portfolio is populist rather than principled. According to one,

> [Standard ethical investments] might variously be more accurately labeled "investments reflecting investors' opinions", "investments reflecting fashionable causes", "scrupulous investments", "ethically simplistic investments", or a range of others. The one term, which prejudges the issues and which is not justified is "ethical". (Anderson, 1996, p4; quoted in Sandberg, 2008, p40.)

A further problem is that, if it is the contradiction of one's moral beliefs and one's real life behavior that makes investing in nuclear weapons as a pacifist wrong, this moral wrong could be undone by simply changing one's moral belief, i.e. become a hardcore warmonger. This conclusion will feel unintuitive to many, which signals that investing in line with one's moral concerns is an insufficient approach to ethical investing. A more objective measure of moral investment seems necessary in order to condemn certain investments. The point is that a robust ethical framework lacks in these kinds of investment portfolios. (See for more detail: Sandberg, pp37-66.)

For a more absolute account of what makes an investment ethical or not, we can claim that it is always morally wrong to invest in an "evil" company. If we can leave the content of what makes a company evil aside for now, this seems like a plausible statement. But what is it that makes investing in an evil company evil? In other words, how does morality "spill over"? One possibility is that it is immoral to profit from other's immoral behavior. However, this quickly runs into the problem that it would then, supposedly, be perfectly fine to invest in a company producing nuclear weapons, which turned out to be unprofitable. The initial claim can be altered by the specification that investing in an evil company *with the intention* to make profit is morally wrong. While this response is not considered in Sandberg's review, an applicable reply is that this would turn all investments intended to make a profit morally prohibited. Imagine, for example, an investor chooses to invest in only one

company, one that behaves perfectly morally, except for the fact that it has a savings account. Let us assume that the money on the savings account is used by a bank to invest partly in index funds, in which a broad range of shares of publicly traded companies are included. This would entail an immoral investment by the initial investor. This conclusion is austere, i.e. it to strict, for it holds that it is morally wrong to invest in far more companies than most proponents of SRI might have in mind. (See for more detail: Sandberg, 2008, pp68-94.)

A final approach to investment ethics can be described as the "responsible investor approach". While this approach is especially relevant to the role of the shareholder, its critique is quite relevant to the approach that I will take in this thesis. To explain this, I will provide a short insight in what is coming. My approach will take the institutional[1] structure of the capital market and consider what is necessary for this institution to achieve its purposes. Then, I will derive the moral obligations of moral agents on the capital market from this structure. Now, the responsible investor approach is similar to mine in that it observes that the institution of the shareholder grants the shareholder certain owner-like rights and privileges, and based on this observation the approach argues that certain owner-like responsibilities follow from this structure. In other words, acting as a responsible shareholder is to act as a responsible owner of the company. In practice, this might imply electing virtuous directors and supporting the company even if it is facing difficult times. Or, as Sorell and Hendry (1994) formulate it: "respecting the purpose of the institution means accepting the responsibilities it implies." (p123.)

The critique to this approach is concerned with is a fundamental problem of deriving moral responsibility from an institutional framework. The relationship strategy poses that the institution of shareholding has a purpose, and it is the responsibility of shareholders to act in accordance to that purpose. However, Sandberg (2008) replies: "Even if we were to contend that the institutional framework surrounding shareholding implies a very specific idea about the responsibilities of shareholders […] why should these be thought to have *moral force*?" (p209, emphasis added.) The

[1] In this thesis, I will often use the term "institution". By this, I understand the set of social norms and rules that regulate our interpersonal behavior. For instance, the institution of investing presupposes the right to freedom of contract, but also typically involves the expectation of a premium in return for the borrowed resources.

responsibilities derived from the institution of a certain occupation, called *conventional* duties are arbitrary, i.e. they would not exist outside this institutional framework. And the mere fact that certain conventions exist does not establish moral duties, as is obvious when considering the conventional duties of etiquette in high fashion dinners. What, then, can attribute moral force to the conventional responsibility of the investor? The answer that Sandberg (2008, p210) gives, quoting Shelly Kagan (1998), I believe is convincing: "[c]onventionally assigned duties only have moral force when this can be derived from something else – consequences, fairness, promising and so on". The responsible owner strategy fails to provide us with the "something else", i.e. it fails to provide us with the moral value of the capital market.

In short, contemporary theory and practice on ethical investment face a number of problems. Firstly, practical ethical investment portfolios often lack a robust ethical framework that explains why the one investment is ethical, and the other is not. Secondly, strict principled arguments on ethical investing often result in austere conclusions, diminishing the possibility of ethical investing. Thirdly, approaches that seek to derive ethical responsibility from institutional framework in which investing takes place fail to provide the normative force of these responsibilities.

1.3 Plan of the thesis

In this thesis, I will be concerned with the moral obligations that are derived from the purpose of the capital market. I will offer an approach to investing that does not solely take account of the moral obligations of the investor, but which aims to provide a more holistic account of the ethics of investing. The first observation I make to that purpose is that investing is adversarial by nature. Joseph Heath (2007) has introduced the term "adversarialism" to business ethics and it signifies a practice that is by nature anti-social, but which is justified by the legitimacy of the institution as a whole. Heath (2006) makes the analogy with the profession of a lawyer, who is by her profession morally obligated to zealously defend her client, even although she knows he is a murderer. Or, alternatively, Heath (2007) makes the analogy with business and sports, where competitive, self-serving behavior is justified for the positive externalities it provides to society. In this thesis, I will argue the same can be said about investing. In

order to defend this claim, it is necessary to prove that investing is, firstly, a form of anti-social behavior and, secondly, that this behavior is justified. In other words, if investing is a necessary evil, we need to show it is necessary and not merely an evil.

The main question of this thesis is: what are the moral obligations of actors on the capital market that can be derived from the institution of investing? In order to answer this question, section 2 will reconstruct Heath's argument on the adversarial nature of business. This will serve, firstly, to illustrate what it means for an institution to be adversarial and, secondly, to give an account of the justification of competitive business. This account will be fundamental to the justification of investing. In section 3, I will turn to the subject of investing and answer the main question of this thesis. Similar to Heath's market failure approach (MFA), my approach will focus on the imperfect justification of the—in my case capital—market and the moral duties it imposes on capital market actors. In section 4, I discuss these finding and introduce a new way to consider the institution of the shareholder, namely as a way to overcome a capital market imperfection. In section 5, I conclude this thesis.

2. The Market Failure Approach

In this section, I will explain why business ethics falls into the domain of adversarial ethics, as argued by Heath (2007) in his market failure approach (MFA). The term adversarialism is used to describe behavior that is otherwise considered immoral, but which in the context of the systemic consequences of that behavior is morally permitted (Applbaum, 1999). By reconstructing Heath's account of the adversarial nature of business, I have two aims. Firstly, I aim to clarify what it means for an institution to be adversarial, in order to lay down the framework in which I will consider the ethics of investing. Secondly, I will later argue that self-serving behavior in investing is justified not only by the systemic consequences of investing itself, but also by the justification of market competition. Therefore, it is necessary to give an account of this justification.

To explain the adversarial nature of business, subsection 2.1 presents an overview the field of business ethics that the MFA aims to improve upon. The problem with this field of business ethics as it stands, is that it cannot consistently satisfy our intuitions of manager morality over the entire range of their activities. In subsection 2.2, I will illustrate why managers are expected to have "moral immunity" to some extent, i.e. why business requires antisocial behavior. Continuing, subsection 2.3 is concerned with the justification for this antisocial behavior. The justification relies on the ability of the competitive market to optimally allocate resources, as guided by an "invisible hand". However, the competitive market does not operate under ideal conditions, and in subsection 2.4 the moral obligations of managers that follow from this non-idealness are covered. Subsection 2.5 summarizes the most important observations of this section and shortly clarifies why the MFA is not concerned with managerial behavior outside the competitive market.

2.1 On the moral obligations of managers

The field of business ethics that Heath responds to is the professional business ethics, which is concerned with the duties and obligations of managers. This field is split in two. On the one side is shareholder primacy, the conventional perspective in business

practice (Stout, 2013). Shareholder primacy holds that the value created for shareholders, the “owners” of the company, should be the *sole* criterion on which the conduct of management should be judged. The relationship between shareholders and management is known as *fiduciary*, which implies that it is the moral obligation of managers to conscientiously manage the assets with which shareholders trust them (Hasnas, 1998). Milton Friedman (1970) famously expressed this idea in his article *The Social Responsibility Of Business Is To Increase Its Profits*, in which he argues that it is fundamentally the task of managers to be concerned only with the interests of shareholders. The shareholder-centric system has been defended in various ways, such as the owner-relationship of shareholders to the company (cf. Horwitz, 1972, p73), their lack of protection against managerial opportunism (Heath, 2006, pp538-40) or the beneficial effects shareholder primacy has on society in general (Hansmann and Kraakman, 2000). However, the apparent “everything-goes” approach of shareholder primacy has been widely criticized in business ethics, which has inspired the development of an alternative theory, namely stakeholder theory.

Over the past decades, some version of stakeholder theory has been the conventional perspective in the field applied business ethics (Hasnan, 1999, p3). The core of the argument is the premise that “managers bear a fiduciary relationship with [all] stakeholders” (Freeman, 2010, p39). Freeman derives this fiduciary relationship from the categorical right of all stakeholders not to be treated as a means merely, but always also as an end. This implies that stakeholders should be able to “participate in determining the future directions of the firm in which they have a stake.” (p39.) From the fiduciary relationship between managers and stakeholders it follows that management should try to advance the interests of all stakeholders, including shareholders. Freeman suggests that management should operate similar to “King Solomon” in balancing the interests of stakeholders. Much has been said and written on the force of stakeholder theory (cf. Parmar *et al.* 2010), and it has been greatly influential in business practice, but I will focus on a critique that holds most power to many, namely that stakeholder theory “yields ethics without business” (Goodpaster, 1991).

Friedman (1970) too expresses the worry that stakeholder theory (or rather, its predecessor: corporate social responsibility) has little to do with business, as he

criticizes the notion of managers acting socially responsible. If a manager decides to act socially responsible, Friedman argues, this would raise the price of the product or service the firm supplies, thereby lowering the profits of the company. Since shareholders are residual claimants of the company, which entails part of the profits of the company belong to shareholders, the result is that socially responsible managers spend shareholders' money on public purposes. Such practice would essentially be the same as taxing the shareholder, which privilege is reserved for government only. Similarly, Goodpaster (1991, p65-6) poses that a formal understanding of managers having a fiduciary relationship to stakeholders "represents nothing less than the conversion of the modern private corporation into a public institution and probably calls for a corresponding restructuring of corporate governance" (p66). Indeed, the fundamental aspect of the private sector is the liberty of individuals to pursue private interests. Does this imply, then, that shareholder primacy is correct in stating that the only moral obligation for managers is to pursue private interests?

Most of us would deny this is the case, as the shareholder-centric system is not "ethical" enough to satisfy many people's intuitions. For instance, if polluting the environment is essential to a company's success, shareholder primacy dictates that management should not refrain from polluting the environment. Instead, management should act as to pollute the environment as much as necessary in order to maximize shareholder value, within the extent of the law. Moreover, according to pure shareholder primacy, if the benefit of breaking the law is high enough, and if the risk of getting caught is low enough, then management should still break the law in order to maximize shareholder value. As shareholder activist Robert A.G. Monks states:

> Again and again we have the problem that whether you obey the law or not is a matter of whether it's cost effective. If the chance of getting caught and the penalties are less than it costs to comply, people think of it as just a business decision. (*The Corporation*, 2003, timestamp: 37:04)

Indeed, this mindset is counter to most of our intuitions of corporate value creation. Goodpaster (1991) shares the concern that shareholder primacy's focus on shareholders is too single-minded; he suggests a golden mean alternative. Goodpaster poses that management's fiduciary duties towards shareholders should be limited, not

by fiduciary duties to stakeholders, but by *non-fiduciary* duties to stakeholders. The non-fiduciary duties that Goodpaster proposes are fully in line with the fiduciary duties of management, because these duties should be *derived from* shareholders duties. To explain this, Goodpaster states: "No one can expect of an *agent* behavior that is ethically less responsible than what he would expect of himself" (p69, original emphasis). In other words, managers cannot be expected to execute those orders *shareholders ought not to put in practice themselves*. Thus, regardless of the end that is pursued, the agent (manager) can never claim to have "moral immunity" from the everyday morality of the principle (shareholder).

In order to illustrate this, let us briefly return to the example of pollution. According to Goodpaster's account, management is (morally) allowed to pollute the environment only to the degree that shareholders are (morally) allowed to do so. And the extent to which shareholders are (morally) allowed to pollute the environment should be laid out in our everyday morality. The allowed amount for managers should thus not be: "as much as the law permits, and possibly even more"; rather it should be: "as much as everyday morality permits, and certainly no more." This does not solve the myriad of ethical dilemmas managers face today, but it does accommodate managers with the possibility to respect the interests of stakeholders without violating their fiduciary relationship with shareholders.

2.2 On the antisocial side of business

Now, we can return to the aim of this section, which is to explain the adversarial nature of business. Heath's crucial observation is that Goodpaster is mistaken in saying that no end can offer an agent "moral immunity" from our everyday morality. On the contrary, Heath argues, the competitive market, insofar as it demands certain types of non-cooperative behavior, *does* extend managers a limited amount of moral immunity to our everyday morality. Indeed, Heath (2007, p369) observers how "[m]anagers are expected to be tough negotiators, to act strategically in the interests of the firm, to fire unproductive employees, to refrain from nepotistic practices, etc." Let us consider one of these kinds of behaviors outside of their business context.

Imagine two friends, "A" and "B". A really likes apples and therefore has a number of apple trees in his garden. B really likes blueberries and therefore has a number of blueberry plants in his garden. Now imagine that B also likes apples, but is really bad at growing apple trees, because he is too short to prune them. B asks A to share their harvest equally and considering they both put equal efforts in their projects, A thinks this is fair. While A does not quite like blueberries as much as B likes apples, A agrees to share harvests. According to our intuition, A's behavior is morally acceptable. However, the result is that they both produce a similar amount of fruits, while the demand for apples is higher (viz. A's demand + B's demand) than the demand for blueberries (viz. mostly B's demand). In the context of efficiency, this is suboptimal. Indeed, in the competitive market, we expect A to be a tough negotiator who demands money in return for his apples. A's profit will enable A to expand his apple garden. This results in a higher ratio of apples to blueberries on the market, which mirrors the demand for each product. Thus clearly, for the purpose of efficiency, the only *right* action of A is to demand a return for his apples.

To this example, one might oppose it is not clear that asking money in return for one's apples is an outright violation of our everyday morality. I believe this is the case exactly because commercial behavior is to such extent entrenched in the norms of our society. Yet, what matters is that in a competitive business environment, A's behavior is not only allowed, it is *required*. This contrast is the core of the argument that business is by nature antisocial. This being said, it does not imply that managers should act out of self-interest in all business contexts. Indeed, it is only in the competitive nature of business that managers should act antisocially. The relation of the manager with a firm's employees is cooperative rather than competitive and it should follow cooperative norms. For now, we can establish that the competitive market demands antisocial behavior to some extent. Now, for business to be adversarial and not simply immoral, the antisocial nature of competitive business needs to be justified. To this, I will turn in the following section.

2.3 On the justification for competitive business

To explain what justifies the antisocial nature of competitive business, we can turn to business' analogous nature to competitive sports. Competition in sports holds a

special place in morality, for it too requires behavior that would otherwise be considered anti-social. To explain this, consider that oftentimes the “social” thing to do is to apply the Golden Rule before one acts, i.e. to contemplate whether one would approve of that action if another did that to him. In a competitive environment, however, the Golden Rule holds little merit. Heath points out that it is undesirable to expect a football player to question, moments before he scores the winning goal, whether he would “like it if the other team did that to [him]” (2007, p365). Moreover, in the game of football it is allowed to tackle an opponent in order to recapture the ball, even if that runs the risk of hurting the opponent (to a certain extent). The justification for the anti-social behavior in the world of sports is that competition leads to an overall rise in the skills of the contenders. This in turn raises the quality of the game, which benefits spectators and thus, society in general.

The same logic holds true for the competitive market system. The ideal competitive market, namely, leads to what is called a Pareto-optimal outcome, i.e. it leads to a situation in which no one’s state of welfare can be improved without worsening that of any other’s. That is what the “invisible hand theorem” predicts, and what Arrow and Debrue (1954, cited in Heath, 2007, p369) have proven. The mechanism behind this has been a subject of inquiry since Adam Smith (1776) and understanding the mechanism of the competitive market helps us to grasp why competitive behavior is required for an efficient market. This mechanism is explained in more detail by for instance Heath (2007, pp363-4), but I will cover it briefly as well.

Let us start by observing that the market for a certain good is influenced by buyers (who all want to pay as little as possible) and sellers (who all want to earn as much as possible). If a good is sold for a price at which the demand is *higher* than the supply, buyers will be left with fewer goods than they would optimally desire for that price. This will create the temptation for each buyer to offer slightly more for the goods, for every seller will then be eager to sell their goods to that buyer and that buyer will fully satisfy his demand. By this mechanism, although it is in the interest of all buyers for the price to stay as low as possible, the competition between buyers will make the price rise. Vice versa, if the good is sold for a price at which the demand is *lower* than the supply, sellers will have goods left unsold. This will create the temptation for each seller to demand slightly less for his goods, for then every buyer will be eager to buy

their goods from that seller and that seller will sell his entire stock. Again, although it is in the interest of all sellers to set the price as high as possible, the competition between sellers will make the price drop. In this fashion, the optimal price for a good is determined. Moreover, this system makes sure that those who can offer a good at the lowest price will offer that good with most profit. In other words: "The operation of the price system … allows for a more efficient (i.e. less wasteful) use of resources and labor." (Heath, 2007, p364.)

This account of the competitive market illustrates why competitive market actors *should* act self-interestedly, while the justification for doing so is socially oriented. Thus, the aim of the competitive market is to produce a Pareto-optimal outcome, while the aim of the competitors should be to make profit. I have so far discussed the first part of Heath's argument, namely that business is adversarial. I will now consider what conclusions follow from this observation of business ethics.

2.4 On market failures and the moral obligation of market competitors

Of course, the conclusion that an ideal competitive market always leads to a Pareto-optimal outcome does not apply to our non-ideal market. For instance, the ideal competitive market theory assumes perfect informational symmetry between buyers and sellers, which condition is not met. The solution to the imperfections of our market, then, is not to make the other conditions resemble perfect competition as closely as possible. Rather, we should try to design a system which outcomes most closely approximate the ideal system. Abraham Singer (2018) explains the findings of the "theory of second best" as follows:

> If the completely open and competitive market of economics textbooks does not exist, the best bet is not to make the market as competitive as possible; instead, we ought to introduce other institutions that address the absence of those assumptions. (p101.)

Involvement of the state with regard to the competitive market should thus aim to realize outcomes that most closely resemble the outcomes of an ideal competitive market. This includes not only providing society with public goods the imperfect market is unable to provide, such as roads, but also includes regulating market

competitors as to prohibit the exploitation of those strategies that fail to produce an outcome close to the ideal. Just like any form of competition, market competition should be governed by a set of rules that restrict the range of strategies of the competitors, in order to most closely approximate outcomes of ideal competition.

Thus, while it is the role of the individual on the competitive market to act self-interestedly, the purpose of the market remains to produce a beneficial outcome to society as a whole. The actors on the competitive market should be restrained from exploiting those strategies that fail to lead to this beneficial outcome. Heath calls these strategies "*preferred* competitive strategies" (Heath, 2006, p549), which comprise of lowering price, improving product quality and product innovation. In principle, it is the role of the state to allow only preferred practices from market actors, as it is the role of the rules of a sports competition to ensure healthy competition. However, the law is a blunt instrument, and regulation is not always feasible. As a result, non-preferred strategies, which might make competitors more competitive while leading to far from ideal outcomes, can still be used. Such non-preferred strategies include: imposing costs on third parties (i.e. externalizing costs) in order to artificially lower prices; abuse informational asymmetries to sell products with hidden defects; and exacerbate informational asymmetries through false advertising. These non-preferred strategies can lead to market failures: "a situation in which the market [*egregiously*] fails to produce a Pareto-efficient outcome" (Heath, 2006, p549).

In Heath's MFA he argues that it is firstly the task of the state to impose a set of rules on the market, designed to prevent market failures from occurring. This claim is founded on a broad range of existing literature, as reviewed by Johan Den Hartog (2010). State intervention in the market include the allowance of the existence of business firms (cf. Singer, 2018, pp5-6), the provision of public goods that the market is unable to provide for (Den Hartog, 2010, pp15-7) and the restraining of market actors from using non-preferred strategies (Heath, 2006). However, Heath acknowledges the costs of state regulation might diminish its positive effects on efficiency, and since efficiency is the bedrock on which competitive market, in such cases state regulation is antithetical to the purpose of market competition. Rather, it then is the moral obligation of market competitors to themselves refrain from non-

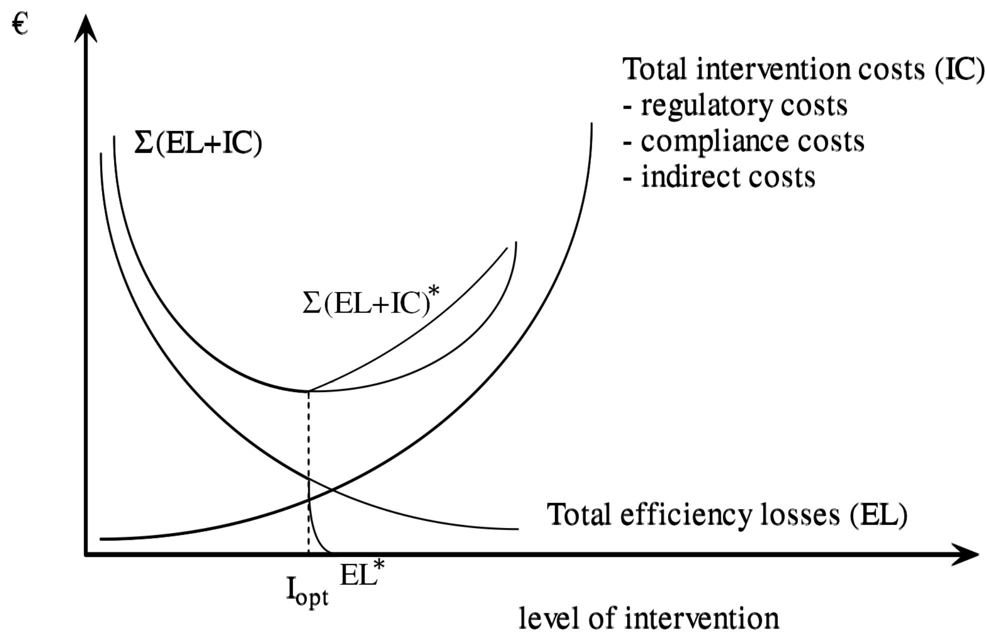

Figure 1 On the costs of public intervention in market efficiency, and the role of morality

preferred strategies that might result in market failures. This is illustrated by Figure 1 (adapted from Den Hartog, 2010). The figure shows the total efficiency loss (EL), i.e. the costs of market failures, which decline as public interventions increase. These public interventions, however, bear costs (IC) to them as well, which rise as public interventions increase. For public institutions, the optimal level of intervention is I_{opt}, for any increase in the level of intervention will decrease overall efficiency gain. Now, Heath's addition to model is that it is the moral obligation of managers to refrain from exploiting market failures. The rapidly declining line (EL*) illustrates the decreased inefficiency if managers indeed do so. Importantly, the decreased in efficiency is exaggerated, as inefficiencies will still occur as a result of non-exploitative behavior. This side-note emphasizes that the MFA does not prohibit *all behavior* that leads to market inefficiencies. Instead, the MFA focuses on the *exploitative behavior* that does so. Indeed, if the adversarial nature of business can be described as "self-serving behavior allowed to produce an efficient outcome to society", then only "self-serving behavior that produces inefficient outcomes" is morally wrong.

It should be noted at this point that the economic market failure approach, which advocates state intervention in case of market failures, has contracted critiques on its descriptive validity. For example, it has been argued that "An economist generally needs only 10 minutes to rationalize government intervention by constructing some

form of market failure" (Peltzman, 1989, cited in: Den Hertog, 2010, p18). However, this does not necessarily imply similar critiques on the normative power of the approach. If the justification for business is to promote market efficiency, and if market failures do exist and are avoidable, this implies that it is wrong for actors in that system to exploit market failures. I thus believe these empirical critiques do not hold force with respect to the normative MFA.

To summarize, morality in business is similar to sportsmanship in sports; it dictates that players act in accordance to the spirit of the rules. Returning to business ethics as a professional ethic of the manager, the role-specific obligations of managers are formulated as follows: 1) managers should refrain from market failures; 2) managers should not cheat the rules (even if this is cost effective); 3) managers should not game the rules (i.e. refrain from exploiting market failures *even if* such practice is not illegal); and 4) managers should take the high ground (i.e. refrain from abusing market failures even if competitors do not). (Heath, 2007, pp370-1.)

2.5 Concluding remarks on the market failure approach

This section has shown how one might derive the role-specific obligations of a certain occupation from the institutional framework surrounding that occupation. In the case of managers, the institution of the competitive market prescribes certain obligations of the manager. Furthermore, the competitive nature of the market goes against the cooperative nature of social behavior and our everyday morality. Therefore, it is in need for a justification. This justification is given on the basis of efficiency. The ambition to maximize efficiency further directs the role-specific obligations of market actors as to restrain from acting in a way that shifts society away from increased efficiency, i.e. it puts the moral constraint on managers to refrain from exploiting market failures. One might oppose the idea that efficiency alone serves as sufficient grounds for competitive behavior (cf. Singer, 2018). Still, the institution of the market has been instituted to serve efficiency and is theoretically capable to achieve this end without hindering other ends (Blaug, 2007). This being said, essential to the MFA is that competitive behavior is only justified in the scope of the competitive market. In other words, the individual pursuit of profit at the "expense" of others is only allowed

with regard to competitors and customers, and not to other stakeholders, such as employees and affected third parties.

To explain this, Heath makes the distinction between "administered transaction", transactions that are controlled by the cooperative structure of the firm, and "market transactions", transactions that take place on the competitive market (Heath, 2007, p359). The distinction helps to separate adversarial and non-adversarial behavior. The failure to do distinguish between the two, so far, "has led many business ethicists to develop a ''uniform'' moral code, suggesting that the same test, or that the same standards be applied in all circumstances, and in every transaction." This has lead to ethicists designing standards that are either too high, i.e. not acknowledging the competitive nature of the market, or too low, i.e. not acknowledging such behavior is only allowed in the scope of that market. This section has been concerned with market transactions only, and the competitive nature of the market. The manager was here treated synonymously to the individual market competitor or rather, to the firm he represents, for the manager is in charge of the competitive decisions of the firm. However, inside the firm, the relationship is hierarchical, responsibilities flowing from "employees toward their supervisors, managers toward executives, executives toward the board of directors, and via the board of directors, the shareholders." (Heath, 2007, p367.) Importantly to this thesis, similar to how managers have distinct obligations inside and outside the firm, shareholders do too. They play a part in administered transactions, practicing their voting rights for instance, and in market transactions, trading their financial shares on the capital market. Little light has been shed on the obligations of the shareholder and the adversarial nature of shareholding. In the next section, I will provide a start to this debate, exploring the moral obligations that can be derived from the institution of investing and the capital market.

3. The Ethics of Productive Investing

As the previous section illustrates, some antisocial behavior is justified for the sake of achieving some greater good. In this section, I will argue that this is also the case for investing. To do this, I will consider the *prima facie* objectionable nature of investing in subsection 3.1. This is, similar to the adversarial nature of business, primarily concerned with the self-serving nature of investing. Continuing, in subsection 3.2, I will give a justification for such behavior in the context of the capital market. The justification is concerned the systemic consequences of self-serving investments, namely to increase productivity on the competitive market. In subsection 3.3, I will introduce what I call the capital market failure approach (CMFA), by outlining the imperfections of the capital market. In subsection 3.4 I address the moral obligations of actors on the competitive market in more detail, firstly outlining the proper role of the state on the capital market. In subsection 3.5, I conclude on the CMFA and address three challenges to my approach.

3.1 On the adversarial nature of investing

Investing, as understood in this section, is the act of lending resources to a business firm at an interest. While lending can be considered an act of kindness, lending with interest has been met with resistance throughout history. John Hendry (2013) describes how lending in this manner has long been considered immoral:

> In ancient times, lending money at interest, or usury, was prohibited in China and India, severely limited in Jewish law and tightly regulated in Roman law. It was outlawed in Christian countries in the Middle Ages, remaining illegal in England into the seventeenth century, and was tightly controlled in both the UK and the USA well into the twentieth century. Extremely high interest rates are still outlawed in some US states and usury is still prohibited in contemporary Islam. (p128.)

The historical objection to lending with interest is mostly grounded in the possibility that the poor can be exploited by usury. Indeed, more recent literature on the ethics of lending at interest rates emphasizes that the poor have fewest possibilities to borrow money and therefore lack freedom of choice (cf. Lewison, 1999). Demanding sky-

high returns from these lenders exploits their lack of freedom. Considering this, what can justify the self-serving behavior of lending at an interest rate? This question, while pressing, is not quite appropriate to this inquiry into the morality of investors in business firms. Indeed, investors don't lend money; they invest it.

A more appropriate critique on investing for our purposes, then, is the idea that it is inherently self-serving. It can be argued that the institution of investing demands behavior that is contrary to our everyday morality, similar to how Heath (2007) argues that the structure of the marketplace demands certain types of non-cooperative behavior from managers (Heath, 2007, p369). Indeed, Heath points to the antisocial nature of investing, observing "investors are entitled to withdraw their money from an unprofitable firm, regardless of the broader ''social consequences'' of their doing so." (*Ibid,* p370.) As opposed of a self-serving system of investing, one can imagine a social system of investing comprising of a tax-based system that equally distributes resources to business opportunities on the basis of expert analysis. This would create equal opportunity for investment to all entrepreneurs. However, in reality we use firms we invest in as profit machines, and try to protect our interests as much as possible when the firm is facing difficult times. Investors do this irrespective of, for instance, the job security of firm employees, which is simply not the field of interest of investors. In the context of business, such self-serving behavior is justified by the efficient allocation of goods it produces. Surely, something must justify the self-serving behavior of investors in a similar way.

3.2 On the justification for investing

In order to understand the justification for investing, it is firstly necessary to understand the advantages of a society in which individuals *save*, i.e. choose to forego immediate consumption of a portion of their resources. Saving can take the form storing one's resources, one's money for instance, in a safe. The reason we save money might be to ensure a comfortable life in the future when we ourselves are unable to earn money through labor. Indeed, if we did not save, this would become problematic to society as a whole for two reasons. Firstly, if no one saves his or her money, then others have to step in to help whenever a person is unable to take care of herself. Secondly, as is elucidated by Heath in his yet unpublished chapter on

People's Capitalism, an important part of our productive economy relies heavily on the labor of machines. And, Heath notes, an important characteristic of machines and other so-called "capital goods" is that they need to be replaced. Taken as a whole, society should dedicate only a portion of its resources on *producing* consumption goods, while the other portion should be set aside for the eventual *replacement* of capital goods. Thus, saving is beneficial for individuals in society and for the economy as a whole and it is in line with our everyday morality.

Now, to understand the justification for investing, one has to first understand the drawbacks to saving. A first problem is that the future is uncertain. Consuming resources immediately, rather than saving them for future consumption, will guarantee that those resources are spent well. Moreover, humans tend to value the present at a higher rate than the future. For instance, empirical research has concluded that most of us rather have $100 now, than $150 in a year's time. The amount by which we devalue our future consumption is called the discount rate. This leads to a collective action problem, for overall utility maximized if all people saved some amount of money (e.g. for the replacement of capital goods, as explained above), but individual utility is maximized if all resources are spent on current consumption. This collective action problem could cause our consumption to "eat in to the capital stock" (Heath, unpublished, p319). In other words, saving is prudential, but we would rather spend our money consuming. In order to overcome this problem, and in order to incentivize individuals to forego immediate consumption, some mechanism needs to be installed in order to make saving more attractive.

Arguably, a social system supported by tax revenue is a system of required savings, relative to income. However, in order to efficiently let savings flow to business opportunities in need of capital, an economic solution has been constructed, namely the infrastructure of investing.

The rationale for investing goes as follows: imagine a worker earns more than she spends. Initially, she only has the possibility to save that money unproductively, which is unattractive to her, as discussed above. Imagine, then, that a businessperson comes by and asks her to borrow her money in order for him to buy more machines. This will render his firm more productive. In return, he promises to repay her at a

premium. This now creates for her the opportunity to save money productively, which compensates for the perceived future devaluation of the saved resources. Furthermore, this simultaneously serves to increase the productivity and profitability of the business firm. This account thus justifies investing on the grounds of increased productivity to business firms. Furthermore, it illustrates that investing is self-serving, for saving at an interest rate is in the interest of the worker only.

However, it is important to note that it could well be argued that this in itself is too narrow of a justification for investing. What renders the productivity of firm of such importance that it justifies self-serving behavior of investors? In order to answer this question, the moral value of increased productivity of business should be made explicit. The account of competitive business as worked out in the previous section (the MFA) does this, as it justifies the self-serving behavior of market actors on the grounds of efficiency for society as a whole. With the “invisible hand theorem” to support its claim, the MFA emphasizes that competitive behavior is necessary for the optimal allocation of resources. The productivity of the firm is an essential part of this competition, because increased profitability leads to increased efficiency. The justification for investing thus not only resembles the justification for the competitive market, *it relies upon it*.

Today, almost all savings are investments, for all money deposited in a financial institution (such as a bank or a pension fund) is made available for lending or investing in order to generate income (Hendry, 2013, p89). The ubiquity of saving with interest through financial institutions signals we consider the productivity gains of investing to outweigh our moral concerns for it. However, the MFA recognizes the competitive market system is non-ideal, from which certain restraints on managerial action follow. Similarly the system of investing might be non-ideal as well. In the next section, it is discussed what restrictions and obligations should follow from the adversarial nature of investing.

3.3 Introducing the capital market failure approach

In order to specify the obligations of actors on the competitive market, let us first consider the mechanism that regulates its prices. The amount of resources society

chooses to invest depends on 1) the willingness of individuals to invest in business opportunities, which is composed again of the monetary attractiveness of investments and on individuals' willingness to take a risk, and 2) on the demand for investments. The attractiveness of an investment is its expected return, which can be thought of as the interest rate of an investment. Let us assume the willingness to invest (1) only changes as the risk of investments change and as their expected return changes.[2] To illustrate: if two entrepreneurs seek to borrow money and offer a similar interest rate on the borrowed money, then the investor will always choose the less risky business opportunity to invest in. Similarly, if two entrepreneurs want to pursue opportunities at a similar risk, the investor will always choose to invest in the opportunity that promises the highest interest rate. For now, it is not relevant how exactly a judgment is made considering two opportunities of which both the risk and the return differ. Considering these assumptions, how does the price mechanism of investments operate? A highly simplified account of the competitive market will be given to answer this question:

Let us call the sum of resources that people are willing to set aside for investments, the "pool of investments". From this pool entrepreneurs can borrow funds at a certain interest rate. If the interest rate is set at a "too low" standard, not enough people will be willing to forego consumption and invest their funds. As a result, the pool of investments is too small for all (expected) profitable business opportunities to be pursued. This will create the temptation for entrepreneurs to offer a slightly higher than average interest rate, in order to make sure their opportunity will be invested in. All other entrepreneurs pursuing profitable business opportunities then will have the incentive to follow, in order to make sure their opportunities will get funded. As a result the average interest rate rises, which will attract more investors and enlarge the pool of investments. This process will continue until the demand for investment funds equals the supply. Vice versa, if the pool of investments is too large at a certain interest rate, entrepreneurs will be able to offer a lower than average rate of interest while still being able to borrow enough money to pursue their business opportunity. This will result in a lowering of the interest rate until the supply of investment funds equals its demand (Heath, unpublished, 321).

2 This assumption is similar to the assumption in the Capital Asset Pricing Model (CAPM) that investors value securities (e.g. shares, bonds, etc.) only on the criteria of "risk" and "return" (Stout, 2003).

Let us now consider the role the investor plays in the institution that is the business firm. The entrepreneur is in need of capital in order to increase his firm's productivity. The investor offers him this capital, out of self-interest. Such self-interested behavior is required for investment funds to be allocated most efficiently, i.e. for money to be invested in those firms that have most to gain from that investment. A financial market guided by self-interest is thus necessary for investments to flow to those business opportunities that have most to gain from these investments. This goal is worth pursuing, even in spite of the antisocial behavior it requires, for it optimally increases business productivity. Increased business productivity, in turn, is necessary for the competitive market to function as to produce an optimal allocation of resources in society, as explained by the MFA.

Now, it is important to note that in the MFA, competitive market behavior by business firms is justified on the account that such behavior serves to produce an efficient distribution of resources. Accordingly, the institution of investing is justified on the account that self-serving investments in fact serve to efficiently allocate resources. This holds true *not only* with regard to the efficient allocation of resources for investing purpose, but also with regard to the effective allocation of resources in society in general.

In case of an ideal capital market, in which it is possible to accurately calculate the risk and return of business opportunities, we can expect resources to be distributed efficiently. Or more precisely, since uncertainty is inherent to the context of investments, the capital market will then be expected to distribute resources as efficiently as possible in light of all available information (Stout, 2003, pp639-42). However, the capital market is not ideal. As was already observed by AG Hart in 1949, theories assume perfect capital markets, "Yet everything we know about business finance stresses the imperfections of the capital market." (p171.) These imperfections can lead to a suboptimal distribution of resources in the following ways: Firstly, the *dependency of the firm on investment resources* often results in great influence of investors of the business practice of the firm, especially in the case of small businesses and start-ups. While this does not inherently lead to a suboptimal distribution of resources, I will later argue it can. Secondly, *information asymmetries*

on the capital market create the possibility for the firm to overestimate returns or underestimate the risk of an investment. For instance, the imperfect information on firm behavior will cause adverse selection of the more risk-taking firms, since they are willing to offer the highest interest rates (Jacobs and van Wijnbergen, 2007). Thirdly, investors are *risk averse*. As a result, investors will not demand an appropriate return relative to some risk. Instead they demand higher than optimal returns on investments, which will lead to artificially raised interest rates and a suboptimal distribution of investment resources (Dixit, 1992).

These instances, of when the capital market fails to serve the purpose of producing an efficient distribution of (investment) resources, then, can be called a *capital market failure*. A capital market failure, then, can occur in one of two levels. A first-level capital market failure occurs when the capital market fails to distribute investors' resources to the business possibilities that have most to gain from these resources. This could occur for instance when a business opportunity is "oversold", i.e. that either its return is overstated or its risk is understated. The result of such failure is that investment resources unjustifiably flow to high-risk or low-return investments. In contrast, a second level capital market failure occurs when the capital market does in fact distribute investors' resources to the business opportunities that have most to gain from these resources, but that those opportunities' increased productivity is the result of a market failure. A second-level market failure could occur for instance when a firm externalizes costs (exploiting a market failure), thereby artificially raising its profits, which allows it to offer a higher return on investment.

Considering the self-serving behavior of investing is justified on grounds of both capital and competitive market efficiency, such behavior is unjustified if it leads to either first- or second-level capital market failures. In broad terms, then, the duty of those active on the capital market is *to restrain from exploiting both levels of capital market failures*. For this reason, I will call this approach the capital market failure approach (CMFA).

3.4 On the role-specific obligations of actors on the capital market

If the CMFA demands from actors on the capital market to refrain from exploiting capital market failures, we can now consider what the role-specific obligations of actors on the capital marker should imply. On the capital market, the competing players are: the investor and the person who represents the business firm (from hereinafter: the firm); and the arbiter is: the state. Interestingly, while the MFA only recognizes role-specific obligations of one side of the competition, namely of the seller, i.e. the manager, the CMFA acknowledges that both sides can exploit capital market failures. Indeed, the firm is dependent on the investor for its resources, while the investor is dependent on the firm for information. I acknowledge this could be claimed as well with respect to the buyer and seller relationship, where the informed seller and the wealthy buyer are co-dependent. However, this fails to take into account to what extent firms are dependent on investors for resources. Having laid out the playing field of the capital market, I will in the final part of this section consider the role-specific obligation for each capital market actor separately, starting with the state.

3.4.a the role of the state

The state sets out the basic rules by which commercial activity takes place and regulates such activity to ensure these rules are respected. This includes the establishing and protecting of property rights, but also the provision of public goods and the setting of minimum standards for product quality (Den Hartog, 2010, pp5-17). All these instances can be described as fixes to market failures, and the state does well to intervene in the market as long as the overall net efficiency increases through such interventions.

Considering that the justification of the capital market too is based on an idealized theory, which predicts that competition will lead to an efficient distribution of resources, and considering that it is reasonable to expect that the non-ideal nature of the market leads to inefficient outcomes, it can be established that the state should jump in to restrain competition that produces inefficient outcomes. Certain regulations are already in place for this purpose, such as the right to freedom of contract and the set of property rights, which protect investors and firms alike. Further regulation can

be installed, but only to the extent that such interventions produce a net increase in efficiency to society. For instance, Jacobs and Van Wijnbergen (2007) suggest government should intervene in the capital market for financing higher education of students, by implementing an equity and insurance system funded by a graduate tax. Because, as they show, such intervention produces a net rise in overall efficiency, the intervention is justified.

Government intervention in the capital market should thus only be undertaken to the extent that it increases net efficiency. However, individual behavior of capital market actors, e.g. not fully disclosing all available information, can be difficult to control, while they directly affect market efficiency. In such cases, the conclusion should not be that this is the best we can do. Rather, the purpose of the capital market morally demands capital market actors to act in such way as to restrain from exploiting capital market failures.

3.4b the role of the firm

Act in accordance to the MFA

The CMFA cannot be seen separately from the MFA, as the justification for the capital market relies upon the justification for competitive business in general. As a result, a first obligation of firms on the capital market is to borrow only for business practices that do not seek to exploit market failures. Understandably, one might question whether this restraint actually is relevant to the capital market. I believe it is, for if a firm does not act in accordance to the MFA, i.e. if a firm *exploits* a market failure, that firm becomes more competitive. The competitiveness is reflected by its profitability. And considering that firms that are more profitable can offer higher returns, we can conclude that firms exploiting market failures might outcompete firms on the capital market. Therefore, an efficient capital market demands of firms to refrain from pursuing business opportunities opposing the MFA.

Restrain from exploiting the informational edge on investors

The main edge firms have over investors is that they are better informed. Part of this edge is the result the expertise a firm can be expected to have in its sector. This

asymmetry, however, does not per definition exist, i.e. one can imagine it does not. The other part of the informational edge is consists of the information the firm has on its own capabilities and motivation. To illustrate this, imagine both the investor and the firm to be individuals. Suppose the individual representing the firm knows of himself that he is lazy. This will decrease the attractiveness of the investment. However, the investor cannot know what the behavior of the firm will be after the investment is made. Therefore, this information asymmetry is true per definition (Keynes, 1936, Ch11, IV). As a result of exploiting the informational edge on investors, an adverse selection towards risky investments might occur. The mechanism behind this is as follows: considering the interest rate is the most direct indication for the success of an investment, and considering high-risk investments can offer higher interest rates (because generally high risk equals high potential returns) the capital market will adversely select high-risk borrowers (Stiglitz and Weiss, 1981). Moreover, considering productive investments are irreversible, this adds to the moral hazard of firms to act irresponsibly, for the investor then has more to lose than the firm. Contract protection to a certain extent protects investors from irresponsible behavior by the firm. However, to the extent that it does not, I pose that it is the moral obligation of firms to refrain from exploiting these informational asymmetries. This implies that firms should be outright about their business practice and duly handle borrowed assets.

3.4c the role of the investor

Only invest in those firms that act in accordance to the MFA

Investing in companies that do not act in accordance to the MFA will aid them to pursue business opportunities. This will increase their chances of “winning” on the competitive market. The increased competitiveness is added to the edge they already gained on competitors by exploiting market failures in the first place. As a result, firms that exploit market failures can offer increasingly higher returns than firms that do not. Thus, if one invests in firms that refrain from acting in accordance to the MFA, one exploits not only the imperfections on the capital market, but one also exacerbates imperfections on the competitive market. It follows that investor are morally obligated to refrain from investing in firms exploiting market failures.

Do not pressure firms to exploit market failures

Once invested, the investor and firm often agree for some investor-oversight in order to minimize the risk of irresponsible behavior by the investor. In such case, it is obvious that pressuring a firm to act in disagreement with the MFA is antithetical the purpose of investing. Moreover, this deals with a challenge that is confronted by Heath in his MFA, which recognizes that in the context of the market, the outcome of losing the competition can be severe (2007, p371). If a firm is unable to compete with other firms, the result is not that its profits will slightly decline. Instead, profits will be reduced to zero and that the firm ceases to exist. Importantly, the pressure to defect is exacerbated by investors demanding high rates of returns. This pressure is alleviated if investors only invest in firms that act in accordance with the MFA.

Refrain from investing to make a change (except for efficiency)

A major strategy in the SRI movement is the activist strategy (Sandberg, 2008, p31). This strategy entails investing in a firm in order to use the acquired influence to change the unethical practice of that firm. This strategy abuses the dependency of the firm of the investor to push one's own political agenda. I believe that this is immoral for the following reason. Consider a firm that produces guns. Some people might sharply oppose the practice of selling guns, while others might believe that we should be free to buy guns under certain conditions. A pacifist might be inclined to become an activist investor, strategically sabotaging the firm. However, I believe the question to whether guns should be produces is a political decision. Interventions by capital market actors in business practices that are legal, not because it is inefficient to prohibit such practices, but because of sincere political motives, are economical interventions in political decisions. Especially considering that activist investor can only make a change if they have sufficient resources, investor activism entails a form of political inequality through economical inequality. While the latter inequality is justified on the grounds of our perception of a just society (cf. Rawls, 1971), the former is not (cf. Beitz, 1989). How should investors, then, act in the case of a firm that exploits market failures? Does such an instance justify the activist investor approach? Or should the investor disinvest, taking the losses? In the end, these questions should be answered empirically. Making a change is justified to the extent that it improves (capital) market efficiency and, in that light, the least inefficient approach should be taken.

3.5 Concluding remarks on the capital market failure approach

To summarize the CMFA, the state should establish a capital market in which capital market failures are prevented as much as possible. These state interventions are justified to the extent that they produce a net gain in efficiency to society. In order to minimize the residual social costs produced by capital market failures, firms and investors should restrain from exploiting these capital market failures. More concretely, the capital market demands of firms that they 1) act in accordance to the MFA and 2) restrain from exploiting the informational edge on investors. Furthermore, the capital market demands of investors that they 3) only invest in those firms that act in accordance to the MFA, 4) do not pressure firms to exploit market failures and 5) refrain from investing to make a change (except for efficiency).

Let us now consider how this ethic of investing, concerned with all actors on the capital market, stands up to the challenges brought forth in the introductory section. To refresh the reader’s memory, I will shortly list these challenges: The first challenge pointed out the lack of a robust ethical framework to support ethical investment portfolios. The second challenge stressed the severity of the conclusions that should follow from principled investment strategies. Indeed, the question arises whether one should invest at all, according to these theories. The third challenge asserted that theories of “responsible investing” fail to provide the normative link between the institution of investing and the moral obligations of the investor. Of the three challenges, I believe the second and third challenges are especially relevant. Therefore, I will consider both, after which I will also consider another challenge, aimed at my conclusion that “investing to make a change” is hardly ever permitted.

I will begin with the challenge of severity. It could well be argued that the CMFA bears austere conclusion and that strictly following it would result in a boycott of all investments. Indeed, Singer (2018) notes that “much of what is required by managers under the MFA still winds up being overly demanding in the context of the actual conditions of the market economy.” (p105.) Considering that the CMFA demands of firms and investors to refrain from engaging and investing in business that exploits market failures, the CMFA can be expected to be equally, if not more, demanding.

This is especially problematic as the MFA aims to stay close to the reality of the market.

Here, I have to admit that a strict application of the CMFA in the current commercial landscape might well entail that one should refrain from investing in most, if not all, companies. To nuance this conclusion, however, I want to bring up three defenses. Firstly, as Singer (2018) also notes, such an approach might serve as an aspirational theory of investing, “one that takes seriously the normative underpinnings of markets and firms, and shows how, on those terms, ethical managerial behavior could be in the service of social justice.” (p112.) Secondly, both market failure approaches prohibit the exploiting of market failures, not the causing of them. This is important, because the concept of exploiting a market failure signifies a motivation to profit from that market failure. A factory that knowingly pollutes the river in order to reduce expenses is “more exploitative” than a transporting service that makes use of coal-fired electricity to power its trains, while both firms pollute. This supports the inspirational line of defense, in that it provides a principle to judge businesses on. Thirdly, as noted in section 3.4b, the CMFA highlights and partly solves a challenge to the MFA, namely that competition pressures managers to exploit market failures. The CMFA explains that part of this pressure is due to investors demanding high returns, and suggests that this is immoral.

I will now turn to the challenge of the connection between an institution and the moral obligation of actors in that institution. Sandberg (2008) refers to the etiquette of high society dinners and argues that the conventional duties derived from that framework can hardly be called ethical. The moral obligations of a structure should follow from a principle that holds normative force, such as the consequences of a certain behavior. If investing is justified on grounds of its benefit to society, why not simply take a shortcut and provide social benefit directly?

Indeed, I believe that it can well be argued that an individual’s money can be put to better use when donated to poverty relief than when invested in a business opportunity. However, economic efficiency is an essential part of our society. As Keynes is quoted to have written: 'the political problem of mankind is to combine three things: Economic Efficiency, Social Justice and Individual Liberty.” (Keynes,

1931.) Considering that efficiency is an important principle in our society, we should take serious the morality of the institution that is installed to provide it. The moral value of the conventional duties of actors on the capital market can then be explained as follows: the practice of investing is self-serving and justified on grounds of efficiency. Acting self-servingly but in opposition of the efficiency is immoral, for it turns a necessary evil in a mere evil.

Finally, the conclusion that the CMFA prohibits the activist investor strategy, except for the purpose of efficiency, might raise questions. In the MFA, for instance, it seems that it is only wrong to exploit market failures, i.e. using market failures to one's own advantage. A firm that is established to bring sand to the beach, or to bring coals to Newcastle, might be inefficient, but not immoral. Indeed, Heath (2007) states: "*Taking advantage* of externalities, information asymmetries, and market power represent the primary forms of unethical conduct in this regard." (p370, emphasis added.) Similarly, if a beer producer becomes (ethically) concerned about the consequences of alcohol, he has the right to start producing alcohol-free beers. So why does an investor not have the right to change the ways of a company by use of her investment.

The claim that the competitive market demands of investors to "refrain from investing to make a change" was defended by alluding to the political inequality such practice brings forth. In this argument, I actually follow Friedman (1970), as he states that the socially responsible businessman "becomes in effect a public employee, a civil servant, even though he remains in name an employee of a private enterprise." (p3.) I believe that indeed, a manager is not a virtuous manager if he decides to act in a way that he beliefs is right, without thereby remaining true to the purpose of a manager, namely to manage a firm as to maximize its competitiveness. In this light, I believe that an investor might actively invest in—or avoid—certain commercial sectors, but that she should not abuse her influence in a firm to act as a civil servant.

4. Discussion

In the previous section, I have argued that investing is self-serving and therefore needs to be justified by some greater good. The greater good can be traced back to the efficient allocation of resources through society, benefitting society as a whole. Continuing, I have argued it is the state's task to restrict the behavior of market actors in order for the capital market to in fact produce the desired efficiency. However, if state interventions cease to produce a net efficiency gain, i.e. if intervention costs exceed intervention gains, these interventions become unjustified. Activities of actors on the capital market that require such inefficient interventions are morally wrong. Therefore, it is the moral obligations of actors on the capital market to refrain from exploiting capital market failures. In this context, both firms and investors should refrain from—respectively—engaging and investing in practices that oppose the moral rules of the MFA. Furthermore, firms should restrain from abusing their informational advantage over investors, and investors should refrain exploiting their influence over firms. However, one fundamental imperfection of the capital market has been neglected so far, namely the risk-aversion of investors (Sauner-Leroy, 2004).

In the first subsection of this discussion, I will argue that there already exists a mechanism that bypasses the risk-aversion of investors, namely the tradability of corporate stock. Continuing, in the second subsection, I will provide a starting point for the discussion of the role-specific obligations of the shareholder, considering the framework of the CMFA. After this, I will turn to the conclusion of the thesis.

4.1 On the relation between corporations and capital market failures

In this subsection, I argue that a critical characteristic of the corporation, namely the tradability of shares, can be described as a mechanism to overcome market failures caused by the risk-aversion of managers.

Being risk-averse entails that, under uncertain conditions, decision makers overweigh the probability of losses resulting from strategic decisions. This raises the return

demanded on investments, thereby artificially lowering the number of pursued investment opportunities on the capital market. This problem is further ameliorated by the irreversible nature of productive investments. The irredeemable nature of investments will drastically lower future options of the investor, thereby increasing uncertainty (Henry, 1976; cited by Sauner-Leroy, 2004). It has been observed that managers' personal behavior with regard to risky decisions for an important part predicts the actual risk taking of the firm in productive investments (Sauner-Leroy, 2004). This suggests the risk-aversion is not a rational reaction to uncertainty, but rather an example of the bounded rationality of market actors. Considering that this market imperfection is ubiquitous, for it can occur in all sectors people invest in, it is important to address the problem of bounded rationality.

Den Hartog (2010, pp13-5) reviews the regulations currently in place that can be described as intended to fix market failures caused by bounded rationality on the competitive market. These regulations generally involve measures that promote the sharing of information, which serve to overcome the collective action that renders researching and sharing of information unattractive. However, the uncertain nature of productive investments cannot be overcome by sharing information, since the future is inevitably uncertain.

What solution can then be installed to overcome the risk-aversion of investors in case of irreversible investments? I believe that, similar to how the firm has been created in order to overcome the transaction costs inherent to market competition in the presence of uncertainty, the institution of the corporation has been created to overcome the risk-aversion of capital market actors in the presence of uncertainty. Before I defend this claim, I will briefly give an account of the firm as a solution to imperfect markets.

In his classical text *The Nature of the Firm* (1937), Ronald Coase explores the question of why firms exist at all. If distribution of resources is most efficiently realized by the pricing mechanisms of the competitive market, it is unclear why cooperating behavior in firms even exists. Coase explains that the most satisfying answer to this question is that the firm is established to overcome transaction costs inherent to dealing with imperfect informational symmetries (e.g. the transaction cost of making others comply to contracts). Firms substitute the cooperative employer-

employee relationship for the price mechanisms of competitive market behavior (Coase, 1937, p391). The significant difference between the two is that in a market environment, the expectations of agent and principal need to be specified exactly by contracts, while in the cooperative firm only *the limits* of the power of the employer over the employee is specified. Instead of renewably agreeing to contracts, the employer can within these limits direct the firm to improve productivity. The firm, in other words, serves to structurally overcome inefficient market outcomes by eliminating market transaction costs.

I believe that, similarly, the corporation serves to overcome a structural failure of capital markets to produce optimal outcomes. More specifically, I argue that the creation of corporate stock (and thereby the shareholder) is aimed to overcome investors' risk-aversion in strategic decision-making on irreversible investments, by granting the investor an escape. In order to explain this, I will briefly turn to a historical account of the invention of stock.

The introduction of stock as we know it today occurred concurrently with the introduction of the business corporation. The 17th century can be marked as the "Age of Exploration", and many of the explorations were lead by commercial enterprises chartered by the state. These were the first types of modern business corporations. Initially, the accumulated cargo was divided at the end of each voyage. However, the frequent liquidation of the enterprise's assets was extremely inefficient, for it required a constant re-attracting of investments. This inefficiency led the Dutch government to grant the Dutch East India Company (VOC) the right to so-called "tradability of shares" (Hansmann, Kraakman and Squire, 2005, p38-9). These rules stripped investors of their right to withdraw their investments at the end of each voyage, but in return investors gained the right to freely sell their invested "share" of the company. The possibility to freely sell shares increased the liquidity of investments. In other words, investments became reversible. In this sense, the invention of tradable shares has turned irreversible investments into reversible ones.

The introduction of tradable shares is a majorly important characteristic of the modern corporation. In an extensive historical account of the rise of the corporation, Hansmann, Kraakman and Squire (2005) conclude that "entity shielding" (the set of

rules necessary for, among other things, tradable shares) is “both economically and historically more significant than limited liability.” Indeed, David Ciepley (2013) argues that, due to the liquidity of corporate investments through tradable shares, “whenever a large quantity of specialized physical capital is called for, the corporate form becomes the legal form of choice.” (p144.)

The shareholder of today thus is an investor who does not need to commit to an irreversible investment. This is what turns the shareholder-investor into a trader. The justification for the corporate form is that it enabled business corporations to more easily pool investors’ money, which in turn enabled corporation to acquire stable capital and specialize firm assets and labor. The invention of stock thus enabled them to become increasingly efficient (Ciepley, 2013, p143). The corporate form and the construction of the stock exchange can in this light be seen as an intervention to overcome the imperfect nature of investor behavior, compensating for the risk-aversion of investors, especially in case of formerly irreversible investments. In other words, the invention of stock can be seen as a fix to a capital market failure.

Now, the follow-up question is: does the institution of shareholding indeed help to produce an efficient distribution of investment resources? And more importantly, to what extent does it incentivize investors to exploit the institution of shareholding in a way that is self-serving but contrary to the social benefit it is aimed to produce? I will shortly turn to this question in the following subsection.

4.2 On the implications of the CMFA on shareholding

In this thesis, I made the distinction between productive investments and tradable investments. The distinction served to take a more analytical approach to the subject of investing, formulating an ethic based on the basic principles of the system of investing. Furthermore, the distinction also served to highlight a capital market failure typical for productive investments but absent in tradable investments, namely the increased risk-aversion of investors to irreversible investing decisions. If the thesis that the corporate stock can be seen as an improvement on the capital market is correct, we can pose that the institution of shareholding should not oppose the aim of

the capital market (which is to efficiently distribute resources at the benefit of society). The central question when considering the moral obligation of the shareholder in the framework of the CMFA, then, is: what investment strategies available to shareholders are justified in the light of the CMFA?

Firstly, there is the question whether the institution of shareholding is more efficient than the risk-averse investment climate with only irreversible investments. I believe history showed that it is. However, some have argued that the financial market (i.e. the market for tradable securities) is saturated and that financial trades are not productive. Indeed, shareholding is often compared to speculation or even gambling (Hendry, 2013, pp159-184). Furthermore, the market in financial securities such as tradable shares and bonds, the financial market, is often blamed to redirect assets away from productive investments towards the speculative market (e.g. Trumka, 2015; cf. Kliman and Williams, 2014).

Moreover, political philosophers have argued that corporations, and the associated institution of shareholders, are "governmental in provenance (meaning "of" government or derived from government)" (Ciepley, 2013, p141; cf. Van Eeghen, 2005). Considering that the optimal level of government intervention in markets is at the point that further interventions have no further efficiency gains, the question whether the current system of shareholding is most efficient becomes very relevant. A range of research is available on the efficiency of the institution of shareholding, especially with regard to the shareholder-centric system of current corporate governance. Jacobs (2011), for instance, criticizes the short-termism of institutional investors. Furthermore, Rock (2013) points to the costs of shareholder primacy to other essential investors, namely creditors. Stout (2017) similarly argues that shareholder primacy bears hidden costs, albeit not only to shareholders, but to all stakeholders.

A full discussion on the applicability of the CMFA to the institution of shareholding falls outside the scope of this thesis, but I believe this discussion could serve as a starting point of a compelling and, possibly, urgent discussion.

5. Conclusion

The purpose of this thesis was to derive the moral obligations of actors on the capital market from an analysis of the nature and purpose of investing. By observing that investing requires antisocial behavior, I argued that the systemic consequences of investing should justify this antisocial behavior. I conclude that an ethical system of investing relies on a well functioning competitive market. Supported by the framework of the MFA, we can now formulate the moral obligation of actors on the competitive market, i.e. firms and investors, as follows: 1) firms should act in accordance to the MFA and 2) restrain from exploiting the informational edge on investors; and 3) investors should only invest in those firms that act in accordance to the MFA, 4) should not pressure firms to exploit market failures and 5) should refrain from investing to make a change (except for efficiency).

The approach I have taken in this thesis firmly ties the moral obligations from actors on the capital market to the purpose of that market. This might be seen as too much of a market-oriented approach to ethics. Indeed, the conclusion that investing with the purpose to "make a change" should be prohibited, might be unintuitive to many. This might appear to yield business without ethics, leaving issues of social justice aside. I believe, however, that incorporating justice in the market is undesirable, both for the efficiency of the market and for a just society. Ethical investments weigh off concerns for justice against concerns for profit. Indeed, one puzzle that "socially responsible" investment banks deal with is how to invest more responsibly while performing to standard of "the benchmark". I believe that this is mistaken, for it turns morality into a product designed to achieve customer satisfaction.

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